Marvin C. Umholtz, President & CEO
Umholtz Strategic Planning & Consulting Services
1613 Easthill Ct NW   Olympia, WA 98502
(360) 951-9111 cell marvin.umholtz@comcast.net

March 6, 2009

Mary F. Rupp, Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Umholtz Comments on Advanced Notice of Proposed Rulemaking for Part 704 Regarding Corporate Credit Unions

Dear Ms. Rupp:

I appreciate having the opportunity to present these comments to the members of the NCUA Board about the advance notice of proposed rulemaking (ANPR) regarding corporate credit unions. This letter addresses several of the specific questions raised in the ANPR and additionally responds to the NCUA Board's invitation to comment on any other relevant issues pertaining to the corporate credit unions that have not been specifically raised in the ANPR. The views expressed here represent my own professional opinion and do not necessarily reflect the opinions of any client or organization with which I may be affiliated.

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Background on Costly Corporate Credit Union Stabilization Plan

On January 28, 2009 the NCUA Board announced what many industry analysts believed was just a down payment on an extensive corporate credit union network rescue plan. "NCUA is acting to add stability to and strengthen corporate credit unions utilizing a three-pronged approach designed to: 1. maintain liquidity, 2. strengthen capital and 3. restructure the corporate system."

The agency further described the specific actions it was taking as part of its corporate credit union stabilization efforts:

- Guarantee uninsured shares at all corporate credit unions through February 2009, and establish a voluntary guarantee program for uninsured shares of all corporate credit unions through December 31, 2010;
- Issue a $1 billion capital note to U.S. Central Corporate Federal Credit Union (U.S. Central);
- Issue an Advance Notice of Public Rulemaking (ANPR) on restructuring the corporate credit union system; and
- Declare a premium assessment to restore the National Credit Union Share Insurance Fund (NCUSIF) equity ratio to 1.30 percent, which will be collected in 2009.

The agency also sent a seven-page letter (No.: 09-CU-02) to all federally insured credit unions that provided more specifics about the stabilization plan, most notably an estimated cost.

The NCUA advised credit unions that the NCUSIF would face an initial liability of $3.7 billion to guarantee the full amount of uninsured member shares (deposits) in corporate credit unions. According to NCUA, the liability amount reflected the potential credit losses within the securities portfolio as well as other factors that could prompt payments under the guarantee and impact the fair value of the guarantee obligation. The liability could increase or decrease following a systemic review of the $64 billion in mortgage and asset-backed securities held by corporate credit unions.

The NCUA letter also described the likely cost of this stabilization program on individual credit unions.

“The expense of the actions will be passed on proportionately to all federally-insured credit unions through a partial write-off of your existing 1 percent NCUSIF deposit, as well as the assessment of a premium, sufficient to return the NCUSIF’s equity ratio to 1.30 percent. The projected average cost for credit unions for the share guarantee is an approximate 48 basis point decline in annual return on assets and a 43 basis point decline in the net worth ratio. The impact on credit unions for the capital infusion to U.S. Central will be an average additional decline in the return on assets of 14 basis points and 13 basis points of net worth.”

The NCUA letter continued, “The combination of both actions results in the average credit union absorbing a total 62 basis point decline in the return on assets and a total 56 basis point reduction in the net worth ratio. Correct regulatory reporting of this action will be included in the supplemental March 31, 2009 Call Report instructions.”

Policy Decisions Behind NCUA Board Action Questioned

Essentially, the NCUA Board declared U.S. Central and the corporate network to be systemic necessities and too big to fail. The NCUSIF is fully guaranteeing deposits in the network well beyond the legally required $250,000 and U.S. Central is getting a $1 billion capital infusion. Some industry analysts also warn that the estimated $5 billion price tag is merely a down payment.

A number of industry observers were puzzled that the NCUA Board didn’t immediately put U.S. Central and certain other corporate credit unions under conservatorship, sell off the good assets – including the payment system services -- and sequester the bad assets until they could be unwound with managed losses.

It is worth noting that during the NCUA's Corporate Stabilization Update webcast February 12, NCUA senior staff said that immediately liquidating the corporates would have locked in an estimated 50 cents on the dollar for underwater asset-backed and mortgage-backed securities. They said under that scenario the estimated hit to the NCUSIF of between $30 and $35 billion would have triggered a recapitalization fully eight times larger, causing a major marketplace retraction by credit unions.

Unless the application of the math is flawed, that adds up to a worst-case potential reduction in ROAA of 4.96 and reduction of 4.48 in net worth for each credit union. That is a serious dilemma, especially if required to account for it all under Generally Accepted Accounting Principles (GAAP) in 2009.

Although an NCUSIF-managed conservatorship remains an option, at the time the NCUA Board instead chose to do what it did to recapitalize U.S. Central, provide guarantees to ensure liquidity, replenish the NCUSIF, and allow the securities to run off. The current Letter of Understanding and Agreement between NCUA and all but four of the corporate credit unions might have the practical effect of an NCUA conservatorship anyway.

Not everyone agrees with the NCUA Board's approach and that approach makes a big difference as to who ends up paying for the rescue – corporate credit unions and their supporters -- or all federally insured credit unions, whether they used the corporate credit union network or not. It literally becomes a decision about whose pocket gets picked and by how much.

NCUA Board Errors in Rescuing the Movement Rather Than Credit Unions

Among the first strategically important questions the NCUA Board Members should ask (and answer) is whether the corporate credit union regulatory rescue model should remain crafted to preserve what some call the "movement," or should it instead protect the integrity of each independent retail credit union and its membership?

Credit Union Times Editor-in-Chief Sarah Snell Cooke hit the nail right on the head in a February 4th opinion essay. "While the corporate credit union network as it stands served credit unions well for a few decades, in economic crisis like this, credit unions must seriously weigh their duty to their members to continue to provide services against their duty to the movement."

Credit unions can no longer afford to carry all of that excess "movement" baggage. Like an entrenched bureaucracy, the movement establishment has expended far too much energy and treasure merely to sustain itself. When times were good, that was sustainable albeit expensive. Now it is no longer sustainable.

The corporate credit union rescue debate will greatly expand the divide between those who prefer a centrally coordinated movement from those who strive for an industry of self-governing independents. The NCUA Board should behave like a safety and soundness regulator and avoid picking sides in this culture conflict. It is not a proper government regulatory agency role to advocate for or on behalf of a specific socio-political apparatus.

The corporate credit union problem needs a solution grounded in solid thinking and focused on business purpose. Any corporate credit union that can continue to demonstrate added value at a reasonable cost has a future. Retail level credit unions stake their reputations and fortunes on helping their members, not preserving the movement. The movement is merely a motivational speech supporting an often-costly infrastructure and is not a true manifestation of credit union statutory purpose.

Each independent credit union will have a productive future only if it places its members' interests first and does not allow the empire builders to drain its resources. Any credit union that acts to serve the über-needs of the movement to the detriment of its own membership opens itself up to lawsuits and dissident recriminations. The NCUA Board should remain neutral and its solution to the corporate credit union problem should respect each credit union's independent strategic focus regardless of the tenets of establishment dogma.

Fix Systemic Risk of Interconnected Credit Union Industry Structure

The NCUA's $4.7 billion stabilization of the corporate credit unions using the NCUSIF has game changing strategic and competitive impact. Although a number of alternative rescue plans have surfaced, there remains no clear agreement on what to do next. All of the best alternatives and most practical longer-term solutions require statutory change, regulatory revisions, and business model alterations.

To some the corporate credit union rescue process has been messy, but revealing. Investors sometimes say that recessions help to uncover flaws in business models. This one has exposed deep cracks. The corporate credit union business model has fractured under the stress of the worst economic downturn in generations.

As a result of the corporate credit union problem, credit unions have become exposed to additional systemic risks due to the interconnected structure of the credit union industry. Although perhaps prudent as an emergency measure, in the longer-term the NCUA Board's current corporate credit union stabilization plan is structurally flawed and will certainly act as a black hole sucking down the future of the credit union industry.

The capital structure of the NCUSIF differs substantially from that of the FDIC in ways that now negatively affect credit union capital ratios and earnings. Additionally, should the housing downturn and recession prove protracted, credit unions may be called on again to shore up the NCUSIF as it deals with increased insurance losses and the cost to manage major problems in Arizona, California, Florida, Nevada, and other economically hard hit states. This also adds contingent risk to credit union balance sheets.

Additionally, because credit unions are member-owned cooperatives, state and federal governance rules allow as few as one disgruntled consumer member with 750 signatures to disrupt a 3 million-member institution. A dissident-driven power struggle could readily ensue over an individual credit union's participation, especially voluntary participation, in a corporate credit union rescue plan that cannot be directly attributed as beneficial to each credit union's specific membership.

It is ironic that the NCUA Board has made staying a credit union so expensive that the calculation of the value of converting to the mutual savings bank charter has improved so dramatically. Now charter conversion can be seen as a move to preserve members' capital.

In recognition of the agency-induced urgency for more strategic choices, the NCUA Board has an obligation to radically streamline the credit union conversion to mutual savings bank charter process. In a supplemental action, the NCUA Board should also remove any public policy or bureaucratic obstacles to mainstream retail credit unions gaining access to alternative and/or secondary capital options.

Not only does the business model for corporate credit unions need to change, but also do the structures of the NCUSIF and the Central Liquidity Facility (CLF). At the retail credit union level changes need to be made to NCUSIF investment accounting, to corporate credit union capital investment accounting, to capital access options, to governance rules, and to financial institution charter choices. The NCUA Board must radically alter this dynamic by seeking appropriate statutory and regulatory changes.

NCUSIF Balance Sheet Issues Negatively Affect Credit Unions

The FDIC was in existence decades prior to the application of federal deposit insurance to credit unions. With its late start, the credit union fund struggled to build assets and equity to equal the relative resources of the bank deposit insurance fund. In an effort to shore up the fund quickly, credit unions were required to place an amount of 1% of insured shares in the NCUSIF and update the amount periodically to match growth in insured savings. As an interim step, the NCUA requires that credit unions pay a special premium to shore up the fund if it drops below a statutory trigger set at a 1.20 ratio of funds to insured shares.

Although banks expense their premium contributions to the FDIC, credit unions were allowed to treat the 1% as an investment that in some past years had even earned dividends. Essentially the same funds are counted twice as assets, once on the books of the credit unions and again by the NCUSIF.

Should the NCUSIF's retained earnings be depleted shoring up problem situations like the corporate credit union situation, then the credit unions' contributed capital is used. On December 31, 2008 the nation's 7,806 federally insured credit unions reported a collective NCUA Share Insurance Capitalization Deposit of $5,953,778,258. Once the contributed capital is valued at less 100%, then each individual credit union must write down its investment in the NCUSIF.

In a worst-case scenario where the credit union industry experienced losses that exceeded the NCUSIF's resources, including the credit unions' investments, then the NCUA could require that the 1% be recapitalized again following a 100% write down. If the problem were big enough it would require multiple successive write-downs and recapitalizations.

Under current circumstances, credit unions need the assurance that there is a reasonable cap on their annual NCUSIF obligation. Otherwise, GAAP practically demands that the 1% investment be considered other than temporarily impaired.

The year 2009 is on track to become the NCUSIF's most difficult year in its history and it is probably too late to avoid a huge GAAP write-down regardless of the final solution to the corporate credit union problem. It is past time that the credit union's 1% NCUSIF investment was converted to an annual expense. A transition period of perhaps five years could be used to smooth out the impact of the change. The NCUA Board should take whatever steps are needed to make this the new reality.

Corporate Credit Union Structural Anomalies Cause Capital Questions

Decades ago, the credit union industry crafted a "bankers bank" infrastructure called the corporate credit union network to provide liquidity and payment services for credit unions. In 1979, a mixed ownership government corporation managed by the NCUA called the Central Liquidity Facility was added to the credit union industry's' banker's bank infrastructure. During 2008, the CLF was provided with a $40.5 billion line of credit from the U.S. Treasury's Federal Financing Bank, and an extension of that level of funding is currently pending in Congress.

As of December 31, 2008 the 7,806 federally insured credit unions reported having $3,469,492,304 in corporate credit union capital instruments called Paid-In-Capital (PIC) and Member Capital Share Deposits (MCSD). PIC is considered first tier capital since its redemption is totally at the discretion of the corporate credit union that was capitalized. MCSD investments are three-year notice term deposits and are considered second tier capital by credit union regulators. Federally insured credit unions reported nearly $29 billion of additional deposits in corporate credit unions on December 31, 2008.

These capital investments are treated as investments by the retail credit union, as equity by the regional corporate credit union, also as equity by U.S. Central Federal Credit Union, and U.S. Central in turn funds the capital stock at the CLF on behalf of the entire network, including any retail credit unions that are involved with a regional corporate credit union. Retail credit unions may join the CLF directly by subscribing to the capital stock of the CLF in an amount not less than one-half of 1 per cent of the credit union's paid-in and unimpaired capital and surplus.

This entire accounting structure needs to be radically altered. Of this multi-level chain, only one of the entities should be counting the funds as true Tier 1 capital.

It is worth noting that at its January 22, 2009 meeting, the NCUA Board approved a reclassification of CLF-funded notes. Prior to NCUA Board action, CLF loans to retail credit unions were booked as assets by U.S. Central Corporate Federal Credit Union, participating corporate credit unions, and the CLF. Now the loans are booked exclusively as an asset of the CLF. This also removed a record volume of CLF loans off the corporates' and U.S. Central's balance sheets, which eased pressure on their capital to asset ratios. To some industry analysts, that looked like a small step toward accounting transparency and recognition of the pitfalls of double counting.

The CLF has evolved into quite a workhorse in recent months. The CLF can also advance funds to the NCUSIF [see 12 U.S.C. Section 1795f (a)(18)] if required. There is now a lot at stake and having Congress extend the higher level of CLF funding has become a critical factor affecting the entire industry.

Should many of the elements of the corporate credit union network not survive the rescue process, the CLF might need to expand its direct to retail credit union liquidity role. At the very least the CLF should retain significant access to the Federal Financing

Bank with the authority to draw upon a multi-billion dollar line of credit. The NCUSIF also needs greatly increased multi-billion dollar borrowing authority from the Treasury.

The government-managed CLF could be modified to totally replace the corporate credit union network and concurrently refocus its mission. Once the consulting firm PIMCO's more rigorous analysis of corporate credit union investment portfolios is complete and has determined the depth of the wounds, the NCUA Board might have the due diligence needed to justify, or perhaps even compel, just such an action.

Corporate Credit Union Unrealized Losses Pose Capital Risks

The Government Accountability Office (GAO) the audit, evaluation, and investigative arm of the U.S. Congress, studied the corporate credit union network periodically over the years. In 2004 GAO staff auditors reported that the…"corporates' limited ability to generate profits – as nonprofit institutions, owned and controlled by their primary customers – constrains their ability to build a financial cushion against adverse financial conditions or unexpected losses." GAO described corporate credit unions' MCSD and PIC as …"relatively weaker forms of capital."

The relevant GAO reports include:

- GAO-04-977 September 10, 2004 *Corporate Credit Unions: Competitive Environment May Stress Financial Condition, Posing Challenges for NCUA*
- GAO-04-849 August 6, 2004 *Credit Unions: Available Information Indicates No Compelling Need for Secondary Capital*
- GAO-04-91 October 27, 2003 *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*
- T-GGD-115 March 8, 1995 *Proposed Reform for Corporate Credit Union Regulation*
- T-GGD-95-107 February 28, 1995 *Credit Unions: The Failure of Capital Corporate Credit Union*
- T-GGD-95-15 October 6, 1994 *Corporate Credit Unions: Condition, Issues, and Concerns*
- GGD-91-85 July 10, 1991 *Credit Unions: Reforms for Ensuring Success*

The structural anomalies identified by the GAO have caught up with the NCUA, the corporate credit union network, and its member credit unions. The recession, credit crisis, and dislocation in the markets for mortgage-backed securities have put extreme stress on corporate credit union capital adequacy. That in turn, puts pressure on the corporate credit union capital investments on the books at retail credit unions. Losses at the corporate credit union level trigger a classic domino effect of write-downs throughout the credit union industry.

At best NCUA's current intervention mitigates, not erases, the corporate credit union network's credit losses and the subsequent need for credit unions to write down their own individual PIC and MCSD investments and/or inject fresh Tier 1 capital. When the NCUSIF gets involved in any corporate credit union rescue plan, whether through guarantees or insurance payouts, the credit unions' investments in the deposit insurance fund are also at risk with no safety cap on the ultimate expense.

As the GAO had opined, corporate credit union capital has proved inadequate and must be reformed. It remains highly problematic as to whether a corporate credit union using the current business model would internally generate the retained earnings needed or attract the outside Tier 1 capital infusion required. Any capital-reformed corporate credit union would still have to replace the lost net worth, attract new outside capital, and continue to deliver cost effective value-added liquidity services even when they are not the only vendor option available to retail credit unions.

The competitive marketplace imposes seemingly insurmountable obstacles to any rapid resolution of this business issue-driven dilemma. It becomes a Catch 22 for the NCUA Board, corporate credit unions, and the credit union industry. The NCUA Board has a regulatory obligation to require capital reform as recommended repeatedly by the GAO regardless of the impact on the corporate credit union network. Corporate credit unions must be adequately capitalized for the risk they are taking and not allowed to transfer that risk to retail credit unions or the NCUSIF.

Strategic Scenarios Facing the NCUA Board Concerning Corporates

From a strategic planner's point of view, the current situation in which the NCUA Board and corporate credit unions find themselves cries out for a radical re-think of their business model and their role in the industry. A thoughtful scenario planner would ask, "Would we organize a corporate credit union today if it didn't already exist? If so, what would we do differently?"

Some industry experts advocate that the corporate credit union network reshape itself by eliminating redundancies in the existing management and governance overhead. Some experts promote consolidating to a single national corporate credit union with six or eight branches. Others suggest dismantling U.S. Central and retaining only six to eight independent regional corporates to serve retail credit unions. Under current circumstances consolidations among the corporates might make them bigger, but would not necessarily make them stronger.

Still others urge the corporates to sell off their item processing facilities, spin off their subsidiaries, and unwind their liquidity operations. There are also those in the industry who believe that attempting to make the existing corporate credit union network whole again would be too costly and would reinforce an outdated business model that has disastrously proved not to work.

Like water, any big mistake in the highly interconnected credit union industry always finds its way down to the level where the real capital sits -- at the retail credit union. Overall, there is enough capital in the U.S. credit union industry to absorb all the corporate credit unions' losses, but at what price? Almost certainly an erosion of long-term competitiveness would result — something that credit unions can ill afford.

Credit unions can no longer risk underwriting a corporate credit union network that is too big to fail or too interconnected to fail. Given the scale of the crisis, the depth of the recession, and the burden of the underlying losses, the NCUA Board's intervention in any corporate credit union is unlikely to be unwound quickly.

One can hope that this misfortune is harnessed to bring about widespread regulatory reform, but it may be a long and painful grind. The credit union industry must regain its equilibrium and strategically focus on revamping the credit union business model for the 21st Century.

The NCUA Board is also encouraged to review my previous comment letters that are still relevant to the current considerations about how to fix the systemic risks inherent in the credit union regulatory, deposit insurance, corporate credit union, governance, strategic business model, and organizational structure. These include:

- *Comments on ANPR for Parts 708a and 708b Regarding Mergers, Conversion from Credit Union Charter, and Account Insurance Termination*, April 2008
- *Comments on Federal Credit Union Bylaws*, June 2007
- *Comments on NCUA Proposed Rule Part 708b, Disclosure of Merger Related Compensation*, May 2007
- *Comments on NCUA Proposed Rule 701.3, Member Inspection of Credit Union Books, Records, and Minutes,* May 2007
- *Comments on NCUA Proposed Rule Part 708a: Conversion of Insured Credit Unions to Mutual Savings Banks,* July 2006

If the NCUA Board Members have questions concerning these comments, please feel free to contact me for clarification or elaboration.

Sincerely,

Marvin C. Umholtz, President & CEO
Umholtz Strategic Planning & Consulting Services
1613 Easthill Ct NW
Olympia, WA 98502
(360) 951-9111 cell
marvin.umholtz@comcast.net

Marvin Umholtz is President & CEO of Umholtz Strategic Planning & Consulting Services based in Olympia, Washington south of Seattle. He is a 33-year credit union industry veteran who has held many leadership positions with credit union organizations and financial services industry vendors during those years. An accomplished speaker and former association executive, he candidly shares his credit union industry knowledge and insight with public policy makers, financial industry executives, and vendor companies. Umholtz also helps credit union boards and CEOs with strategic issues like growth, board governance, charter conversions, proactive mergers, voluntary liquidations, regulatory advocacy, and the growing conflict about the future role of credit unions in the financial services industry.